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## **The political economy of the enhanced HIPC-Initiative**

Michaelowa, Katharina

**Abstract:** Only three years after its initial endorsement by the World Bank and the IMF in 1996, the Heavily Indebted Poor Country (HIPC) - Initiative was considerably altered and enhanced. How did this change come about? Neither developments in economic theory, nor empirical evidence of changed beneficiary behavior can explain the usefulness of this policy shift. The merits of a shift from ex-ante conditionality to process conditionality implied by the link of HIPC debt relief to the elaboration of Poverty Reduction Strategy Papers (PRSP) remain equally unclear. However, the change from the initial to the Enhanced HIPC-Initiative can easily be explained as a result of utility maximization behavior by national and international bureaucrats, politicians and NGO. A politico-economic model suggests that the overall rise of HIPC default risk and the symbolic value of the year 2000 have been the two major determinants of the policy shift.

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# **The Political Economy of the Enhanced HIPC- Initiative**

**Katharina Michaelowa**

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## **Abstract**

Only three years after its initial endorsement by the World Bank and the IMF in 1996, the Heavily Indebted Poor Country (HIPC) - Initiative was considerably altered and enhanced. How did this change come about? Neither developments in economic theory, nor empirical evidence of changed beneficiary behavior can explain the usefulness of this policy shift. The merits of a shift from ex-ante conditionality to process conditionality implied by the link of HIPC debt relief to the elaboration of Poverty Reduction Strategy Papers (PRSP) remain equally unclear. However, the change from the initial to the Enhanced HIPC-Initiative can easily be explained as a result of utility maximization behavior by national and international bureaucrats, politicians and NGO. A politico-economic model suggests that the overall rise of HIPC default risk and the symbolic value of the year 2000 have been the two major determinants of the policy shift.

## **Zusammenfassung**

Bereits drei Jahre nach ihrer Einführung 1996 wurde die Heavily Indebted Poor Country (HIPC) – Initiative von Weltbank und IWF erheblich verändert und erweitert. Wie kam es zu diesem Wechsel? Weder neuere Entwicklungen der ökonomischen Theorie, noch empirische Befunde über ein verändertes Verhalten der Empfängerländer können den Sinn dieses politischen Kurswechsels erklären. Ebenso unklar bleibt der Nutzen aus dem Übergang von Ex-ante-Konditionalität zu Prozesskonditionalität, der durch die Verknüpfung von HIPC Schuldenerlass mit der Erarbeitung von Armutsbekämpfungsstrategiepapieren (PRSP) entstanden ist. Die Veränderungen lassen sich allerdings leicht erklären, wenn man sie als Ergebnis eines Nutzenmaximierungskalküls von nationalen und internationalen Bürokraten, Politikern und NRO betrachtet. Ein politökonomisches Modell ergibt, dass der allgemeine Anstieg des HIPC Zahlungsausfallrisikos und die symbolische Bedeutung des Millenniumjahres 2000 als zentrale Determinanten des politischen Kurswechsels betrachtet werden können.

**JEL classification:** F34

**Keywords:** HIPC-Initiative, political economy of aid, international decision making processes



## **1. Introduction**

The Enhanced Highly Indebted Poor Country (HIPC) - Initiative has provoked considerable economic literature on specific aspects of debt relief and conditionality. However, the general question of how this enhanced initiative came about has not yet been addressed. The resulting sudden changes in World Bank and International Monetary Fund (IMF) sustainability criteria and conditionality requirements have therefore remained largely unquestioned. This paper now attempts to answer the question why this policy shift has taken place.

After a brief description of the original and the Enhanced HIPC-Initiative in section 2, three hypotheses are advanced to explain the policy shift. These three hypotheses reflect plausible arguments under the assumption that the change was brought about by an attempt to improve the efficiency of the original HIPC-Initiative. In section 4, this assumption is dropped and a politico-economic model is developed to explain the Enhanced HIPC-Initiative as a result of utility maximization by national and international bureaucrats, politicians and Non-Governmental Organizations (NGO). Section 5 provides some empirical evidence for the major forces leading to a new political equilibrium, and section 6 concludes.

## **2. What is HIPC?**

The HIPC-Initiative was endorsed in its original form in 1996 by the World Bank and the IMF. The idea was to reduce the debt burden faced by highly indebted and poor countries if their policy orientation over several years reflected the implementation of promising macroeconomic and social reforms. For the first time, multilateral debt was included into the relief program (Holthus 1999, p. 126 and 115).

Two different lines of thought led to this initiative. On the one hand, it follows from “debt-overhang theory” (Sachs 1984, 1986; Krugman 1988) that a debt burden over a certain level heavily impedes the economic development of a country: Financial inflows dry out due to the risk of insolvency, and investment incentives decrease since foreign creditors rather than local investors are expected to benefit from returns. On the other hand, countries ruining their economies through irresponsible policies, should not be rewarded by debt relief. In their case, debt relief would lead to wrong incentives for a



continuation of such policies, to the benefit of the powerful “elite” and to the detriment of the population as a whole.

To avoid the strengthening of highly problematic political structures and economic policies, the initial HIPC-Initiative intended to provide debt reduction only after a six-year period of promising macroeconomic policy (ex-ante conditionality<sup>1</sup>). Poor developing countries exceeding a debt-to-export ratio of 200-250% after exploring all traditional measures of debt rescheduling were considered eligible for the program.

Based on a proposal of the G7 meeting in Cologne, the original HIPC-Initiative was substantially altered in 1999. The debt-to-export ratio expected to be sustainable was reduced from 200-250% to 150%.<sup>2</sup> Ex-ante conditionality was dropped. Instead, potential future beneficiaries of the program had to engage in a nation-wide participatory process in order to develop a national “Poverty Reduction Strategy Paper” (PRSP) that had to be endorsed by the IMF and World Bank and implemented for one year. Total relief under the new conditions that both, widen the circle of eligible countries and deepen the financial impact for each beneficiary, is expected to add up to over 30 billion US\$ in present value terms (2000) as compared to 12.5 billion under the original framework. This cost is divided approximately in half between bilateral and multilateral creditors.

While only few developing countries had shown interest in the original program, the Enhanced HIPC-Initiative (HIPC II) was widely accepted. Until the end of the year 2000, 22 countries had reached the “decision point”, i.e. they had prepared at least an Interim-PRSP accepted by the two multilateral agencies. Apparently, within the new framework, adjustment costs, i.e. the effort of political reform necessary to obtain debt relief, was perceived to be lower, while potential benefits rose.

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<sup>1</sup> “Ex ante conditionality” is defined here as conditionality requiring certain policy conditions to be met prior to the disbursement of any credit or grant (see e.g. Vaubel 1994, p. 51). Note that the term is not used in a uniform way in economic literature. For the exactly opposite use of the terms “ex ante” and “ex post conditionality” see e.g. White and Morrissey (1997, pp. 500 and 504).

<sup>2</sup> For very open economies with an export-to-GDP ratio  $\geq 30\%$  it can be even lower. The criterion is then replaced by the debt-to-revenue ratio supposed to be unsustainable above 250%. To benefit from the use of this alternative debt sustainability indicator, fiscal revenue must be at least 15% of GDP. All debt indicators are calculated in net present value (NPV) terms.

### 3. Why HIPC II?

As long as the mere interest by debtor countries is not considered a sufficient justification of HIPC II, one might ask why the initial program was so substantially altered in 1999. This is the central question discussed in this paper. Was it altered simply because this change was promising in order to increase the efficiency of the program? Three plausible hypothesis that might explain a higher efficiency of HIPC II can be formulated here:

- *Hypothesis 1:* The development of countries eligible for HIPC II suggests that safeguards against political and economic mismanagement have become less important than before.
- *Hypothesis 2:* Economic analysis has evolved and shows that ex-ante conditionality is ineffective. Moreover, recent research now permits to specify more exactly the threshold of sustainable debt.
- *Hypotheses 3:* PRSP are an efficient new instrument to increase incentives for good policy making. The new obligation to develop PRSP replaces traditional conditionality by *process* conditionality. Contrary to what might appear at first glance, this does not mean that adjustment requirements are effectively reduced.

The rest of this section will examine to which extent these arguments could indeed justify the Enhanced HIPC-Initiative.

#### 3.1. The development of economic and political management in HIPC (hypothesis 1)

The shift to HIPC II essentially looks like a major softening of compliance conditions. This could be based on a generally positive assessment of recent developments in the debtor countries. Since economic growth, and hence, eventually, the ability to service one's debt, depend on both, economic and institutional political factors (see e.g. Rodrik 2000; World Bank 2001a), developments in both fields have to be observed. This is reflected in the set of variables presented in Table 1. The rate of inflation is selected as a standard indicator of macroeconomic stability. Government preferences as to the allocation of available funds are measured by the share of health and education spending on the one hand, and military expenditure on the other hand. The effectiveness of political institutions is depicted using the Freedom House Indices of political rights

and civil liberties. Assuming that the original HIPC-Initiative was based on data of the beginning, and HIPC II on information on the second half of the 1990s, all data are compared for the periods 1989-90 and 1996-97.

**Table 1: Indicators of economic and political management in HIPC**

HIPC having reached the decision point by 31/12/00	Rate of inflation, consumer prices (%)		Public health and education expenditure (% of GNP)		Military expenditure (% of GNP)		Political rights index <sup>1</sup>		Civil liberties index <sup>2</sup>	
	89/90	96/97	89/90	96/97	89/90	96/97	89/90	96/97	89/90	96/97
Benin	..	4.19	..	..	2.10	1.30	7	2	7	2
Bolivia	16.15	8.57	4.57	8.86	3.30	1.90	2	2	3	3
Burkina Faso	-0.56	4.24	3.62	2.53	2.95	2.70	6	5	5	4
Cameroon	-0.28	2.86	4.33	..	1.50	2.85	6	7	6	5
Gambia, The	10.22	1.94	6.50	6.82	1.00	3.75	2	7	2	6
Guinea	..	..	3.87	3.97	1.20	1.50	6	6	7	5
Guinea-Bissau	56.90	49.92	..	..	2.20	3.60	6	3	6	4
Guyana	..	5.33	10.08	9.76	2.05	1.10	5	2	4	2
Honduras	16.59	22.00	7.73	..	2.65	..	2	3	3	3
Madagascar	10.40	12.13	..	3.20	1.30	1.40	5	2	4	4
Malawi	12.14	23.37	..	..	1.45	1.00	7	2	6	3
Mali	0.26	3.22	..	4.01	2.20	1.80	6	2	6	2
Mauritania	9.77	4.65	..	..	4.30	2.45	6	6	7	6
Mozambique	43.58	26.63	7.69	..	7.90	2.85	6	3	7	4
Nicaragua	6127.84	10.42	11.29	13.52	21.00	1.60	5	3	5	3
Niger	-1.81	4.11	..	3.89	1.20	1.10	7	7	6	5
Rwanda	2.60	9.71	5.47	..	2.70	4.85	6	7	6	6
Sao Tome & Principe	..	..	..	..	..	1.15	6	1	5	2
Senegal	0.39	2.25	4.79	6.39	2.00	1.65	4	4	3	4
Tanzania	30.84	18.53	4.63	..	1.90	1.45	6	5	6	5
Uganda	47.28	7.07	..	..	3.45	4.10	6	4	4	4
Zambia	115.21	35.54	5.56	..	4.40	1.15	6	5	5	4
Average (of all 22)	21.75 <sup>3</sup>	12.83	6.16	6.30	2.59 <sup>3</sup>	2.15	5.4	4	5.1	3.9
HIPC so far not approved (14)	26.07	53.49	4.21	5.05	3.08	3.70	6.5	5.5	5.9	5.5
Non-HIPC Low In-come Countries (30)	13.08	15.87	7.07	6.62	6.17	4.39	5.4	5.0	5.3	5.1

<sup>1</sup> The Freedom House Index of political rights is a composite index based on an evaluation of the following aspects: free elections, the real power of elected political representatives, the de facto power of the opposition, the right to organize in groups, freedom of domination by the military or other powerful groups, and self determination rights of minority groups. The index is measured on a one-to-seven scale, with one representing the highest degree of freedom and seven the lowest. For further details see Freedom House (2001).

<sup>2</sup> The Freedom House Index of civil liberties is composed of the four components: freedom of expression and belief, association and organizational rights, rule of law and human rights, and personal autonomy and economic rights. The index is measured on a one-to-seven scale, with one representing the highest degree of freedom and seven the lowest. For further details see Freedom House (2001).

<sup>3</sup> Average excluding Nicaragua as it is an extreme outlier.

Sources: World Bank (2001b); Freedom House (2001).

Looking at average data for all HIPC having reached the decision point until end 2000, some positive overall development over the 1990s can indeed be noted. Inflation rates decreased, the share of GNP spent on public health and education expenditure slightly went up, while the share spent on military expenditure fell. The institutional indicators equally improved. This gives some support to hypothesis 1. However, HIPC not yet accepted for the program do not show the same positive development. The endorsement process of the Interim-PRSP seems to lead to a certain pre-selection, substituting for the ex-ante conditionality of the original HIPC program. This does happen, however, in a less transparent way. Looking beyond the broad averages, it must be noted that a couple of highly problematic countries slipped through beyond the decision point and thus belong to the approved HIPC now. Several countries were accepted despite rising military expenditure (often to more than half of all public education and health expenditure combined), inflation rates for consumer goods of over 20%, and the absence of any sound politico-institutional structures.

While, on average, approved and unapproved HIPC appear to have a similar performance than other non-HIPC low income countries, a comparison with a wider range of developing countries shows that much more progress could be made. Asiedu (2001) compares HIPC and 150 other developing countries using a wide range of institutional indicators. She finds an overwhelming evidence of a significantly lower performance of HIPC.

Optimism about future development thus appears to be adequate in some, but by far not in all cases. Safeguards against political and economic mismanagement still seem to be important. Therefore, substantial doubts can be raised concerning hypotheses 1.

### **3.2. The development of economic research (hypothesis 2)**

Hypothesis 2 suggests, that economic research might be at the origin of the shift from the original HIPC-Initiative to HIPC II. In particular, as far as the redefinition of the “sustainable” debt burden is concerned, one would expect to find some theoretical background. However, reviewing recent debt overhang literature does not lead to any concrete findings in this respect. It appears that debt sustainability simply depends on the productive use of the credits, rather than on any specific debt-to-export ratio (Nunnenkamp 2001, p. 6).

In order to check the empirical evidence on potential thresholds, the debt burden of developing and transformation countries can be compared with inflows of non-guaranteed long-term commercial bank loans. It is assumed that the private capital market is a relatively good judge of expected debt sustainability, so that commercial banks will transfer new funds only if a country is supposed to be solvent in the future. Table 2 shows that the share of countries who do receive such private inflows does not vary much with the debt-to-export ratio. Surprisingly, data do not even indicate any negative correlation. More detailed analyses shows that individual countries like Nicaragua, Peru and Zambia attract private bank loans even at ratios of over 350%. In any case, no clear threshold can be recognized, neither at the 150%, nor at the 200% or 250% level. Fixing a particular sustainability limit thus appears to be rather arbitrary.

**Table 2: Debt-to-export ratio and private market expectations, 1999**

Debt-to-export ratio	≤100%	≤150%	≤200%	≤250%
Share of countries receiving non-guaranteed long-term commercial bank loans from private banks and other private financial institutions (net transfers) <sup>1</sup>	20%	25%	28%	27%

<sup>1</sup>Calculations are based on a total of 137 developing and transformation countries for which data are available.

Source: World Bank (2001c)

Let us now come to the question of World Bank and IMF conditionality, i.e. the necessity of linking resource flows to promising economic policies. Recent economic studies show that potential positive effects of debt relief crucially depend on the recipient country's policy environment. On the basis of theoretical and empirical research Easterly (1999, p. 30) concludes that only countries with a clear shift in intertemporal preferences should be granted debt relief. He directly expresses his fears that the promising ex-ante track record requirement of the initial HIPC-Initiative would be weakened on the basis of the 1999 G7 proposal in Cologne. Moreover, Berthélémy (2001) shows that under HIPC II, the positive investment incentives debt overhang theory expects from debt relief crucially depend on the assumption of a welfare-maximizing government.

General empirical research on aid effectiveness reveals that aid funds (implicitly including funds for debt relief<sup>3</sup>) only have a positive effect on a country's economic development if the country follows a path of sound economic policies (World Bank 1998, Burnside and Dollar 2000). Otherwise, aid and debt relief tend to even have negative effects since they strengthen regimes without commitment to economic development. Even if resources are directly spend on poverty reduction or growth policies, the overall effect may be negative due to the fungibility of aid (Burnside and Dollar 2000, pp. 848, 863f.). The conclusion is that substantial financial resources should be channelled only to countries whose governments are really committed to creating a good policy environment. Selectivity should be based on clear performance indicators whereby external and climatic factors should of course be given due consideration (Guillaumont and Chauvet 2001).

The ex-ante conditionality of the original HIPC-Initiative would have provided an opportunity to check this commitment. Unfortunately, there is no empirical evidence on this particular type of conditionality. It was conceived as a selectivity, rather than a traditional conditionality mechanism since it would have implied a long-term observation of individual countries' policies before any decision on debt relief was made. Under very realistic assumptions about the interest structures within developing countries, strong theoretical arguments can be made for this type of conditionality (see e.g. Drazen 2001, pp. 38-41).

In particular, long-term observation would have prevented one central problem of traditional conditionality: the failure to identify real government preferences with respect to the policies imposed. These preferences are based on the government's own position as well as on the positions of powerful local interest groups, and both are difficult to identify in advance. In fact, governments often neither adhered to, nor implemented the conditions, and were hardly ever penalized for this attitude by a reduction or suspension of resource flows (Hermes and Lesink 2001, p. 7). White and Morrissey (1997) formally show that donors generally had no incentive to really insist on the policy conditions they imposed. Moreover, due to the problem of fungibility, even if conditionality is formally respected, aid resources may just substitute for other national resources which are then allotted to different areas in line with national government's preferences (see e.g. McGillivray and Morrissey, p. 123).

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<sup>3</sup> Several donor countries even directly channel at least part of their HIPC debt relief via traditional ODA. In these cases, repayments continue to be requested, but are reimbursed immediately afterwards by a corresponding amount of ODA. One example is the French C2D (contrats de désendettement - développement).

Finally, one major shortcoming of previous forms of conditionality might have been the rather strict concentration on macroeconomic policies. Sound macroeconomic management will only lead to long term positive results if it is embedded in a framework of other policy measures. In the past, adjustments of conditionality have already taken place acknowledging for the high importance of human capital investments, and the effects of income distribution. Recent economic research primarily points at the importance of institutional factors. Many of the arguments are summarized in the World Bank's World Development Report 2001/2002 (World Bank 2001a). They had not been taken into account when the original HIPC-Initiative was conceived.

On the basis of this theoretical and empirical record, rather than weakening ex-ante conditionality requirements, one should have expected an enhancement of selection criteria including the so far neglected institutional variables. Hypothesis 2 assuming that recent economic research could build the rationale of the shift from the original HIPC-Initiative to HIPC II must thus be fully rejected.

### **3.3. The PRSP-process as a new conditionality requirement (hypothesis 3)**

The final hypothesis suggests that in fact, conditionality was not really weakened, but rather enhanced to include precisely the above mentioned new economic insights on the interrelation between macroeconomic, social and institutional policies. Requesting countries to develop their PRSP in a participatory process including representatives of various social and political groups could actually be interpreted in itself as a first step towards institutional reform. It brings together people of different backgrounds, creates new networks and represents, in a certain way, a direct training in democratic processes. Since the process in itself rather than its results are at focus, one might speak of a shift from traditional to "process conditionality" (Foster et al. 1999). As Morrissey (2001, p. 14) correctly points out, bringing together a wide range of different stakeholders and reaching an agreement on a bundle of macroeconomic, social and institutional reforms can be an extremely difficult task. If taken seriously, already the selection of representatives will be very difficult, in particular in countries without any basic democratic structures. In this sense, the process conditionality of HIPC II might indeed be harder, rather than softer than the requirements of the initial HIPC-Initiative.

However, there is no transparency about which of the intended process elements represent real pre-conditions of HIPC debt relief. In fact, it appears that a number of Interim-PRSP have been accepted although broad participation was far from achieved and even involvement of parliament was neglected (Marshall and Woodroffe 2001, pp. 10f., Booth 2001, p. 11). Often, information is available only in English - a fact raising some doubts about who are the real participants in the discussion process. In Rwanda, a Kinyarwanda and French translation of the original Interim-PRSP was available only in April 2001, about four months after the country had passed the decision point (Booth, p. 17).

Civil society organizations (CSO) in many HIPC express another important concern: The whole process is rushed through under tremendous time-pressure (Marshall and Woodroffe 2001, p. 10 and pp. 31ff., Booth p. 18). Given their limited administrative capacity and technical knowledge, CSO need some time to gather information and build their opinion on the various social and economic issues concerned. Otherwise, as it is now, their input possibilities tend to be very limited.

Thus, initiating PRSP development processes could be indeed an interesting and innovative tool to promote democratic procedures and institutional development. However, in order to be effective, such processes need considerable time and effort. The link to HIPC debt relief which governments wish to obtain as quickly as possible thus appears to be extremely counter-productive. Process conditionality, though indeed very demanding if taken seriously, essentially boils down here to the necessity to draft a program linking traditional macroeconomic policies of the IMF to poverty reduction strategies of the World Bank. Under the Enhanced HIPC-Initiative, countries are supposed to develop their own, nationally owned program, but in fact, the low initial capacity combined with the restricted time-frame of generally less than a year make this endeavor fully unrealistic from the very beginning.

Let us now consider the implementation phase that follows once the multilateral agencies have endorsed a country's Interim-PRSP. During this phase, countries already receive parts of the relief promised under the program. Its duration was reduced from three years at the initial HIPC-Initiative to a minimum of one year under HIPC II. This is all that is left from the initial requirement of a long-term ex-ante track record.

Moreover, monitoring criteria have become very vague. Under HIPC II, countries are supposed to be reviewed according to their own monitoring criteria lined out in their



Interim-PRSP. However, most of the strategy papers have actually not defined suitable monitoring criteria (Booth 2001, p. 11). Nevertheless, these papers have been accepted by the two multilateral agencies.

Finally, if traditional conditionality is criticized for having not worked well in the past, it cannot be expected that the type of conditionality introduced with HIPC II will do any better. Besides the already mentioned problems of high speed, limited monitoring and low transparency, this is true for at least two more reasons:

- Overly optimistic projections of future economic development, and
- Negative incentives for good policies.

The original objective of conditionality is to lead countries to a new and sustainable path of economic growth in order to resolve, once and for all, future insolvency problems. This objective is maintained, in principle, under HIPC II. Consequently, PRSP are adopted by the multilateral agencies only if projections do not lead to future debt-to-export ratios above the so-called sustainability level of 150%. However, cross-country analysis of the existing strategy papers reveals that economic projections tend to be extremely optimistic. Countries generally expect long-term growth rates of 5-7%. Many of them plan to base their export growth strategies on the same sectors (such as tourism) while the resulting competition is not taken into account. Alternative growth paths in the event of negative external shocks (such as decreasing commodity prices) are generally not considered either (Marshall and Woodroffe 2001, pp. 17, 25, and 43). Danielsson (2001, pp. 18ff.) points out that Tanzania for instance, unable to carry a debt burden of US\$ 2 billion in 1999/2000, is expected to achieve future export growth rates that will make a debt burden three times as high sustainable in 2010. This requires, in particular, a regular long-term growth rate of non-traditional exports of over 24% per annum. Slight deviations from these optimistic projections will lead to a debt-to-export ratio much higher than the current one within the next decade.

The second concern is that, at least until the final calculation of debt relief for each individual country at the decision point, HIPC II actually creates negative incentives for good and innovative policy management. Countries do have an incentive to just get their (Interim-) PRSP endorsed by the two multilateral agencies, but to do no better than that. Since the so-called debt sustainability level is fixed in advance, and debt relief will be granted down to exactly that level, countries significantly improving their macroeconomic policies and approaching this threshold will see their debt relief

reduced correspondingly. In fact, they might even run the risk of being judged sustainable cases once they reach the decision point. This would reduce their benefits to zero. Apparently, countries are effectively punished for their effort of running good policies.<sup>4</sup>

All in all, it can be concluded that process conditionality the way it is introduced with HIPC II is certainly no promising substitute for the ex-ante conditionality of the original HIPC-Initiative. Therefore, hypothesis 3 has to be rejected. Thus, neither of the three hypothesis discussed here finds convincing evidence through the above analysis. It does not appear as if HIPC II could be explained by gains in efficiency as compared to the original program. Apparently, an alternative explanation is needed for the shift from the initial to the Enhanced HIPC-Initiative.

#### **4. A politico-economic approach to explain HIPC II**

The alternative proposition to be discussed in the following is based on a positive theory of the rational behavior of all main actors in the political decision making process. Since decision making at the World Bank and the IMF takes place within broadly similar structures, the two organizations will be analyzed jointly here. Vaubel (1991, pp. 210ff.) defines the relevant groups of political actors:

- politicians of the national member governments represented at the Board of Governors
- national civil servants (national “bureaucrats”)
- national delegates at the Board of Executive Directors
- international civil servants (international “bureaucrats”), and
- national and international interest groups, e.g. NGO.

Figure 1 shows how the different groups interact and which channels of influence they can use in order to bring about specific policy decisions.

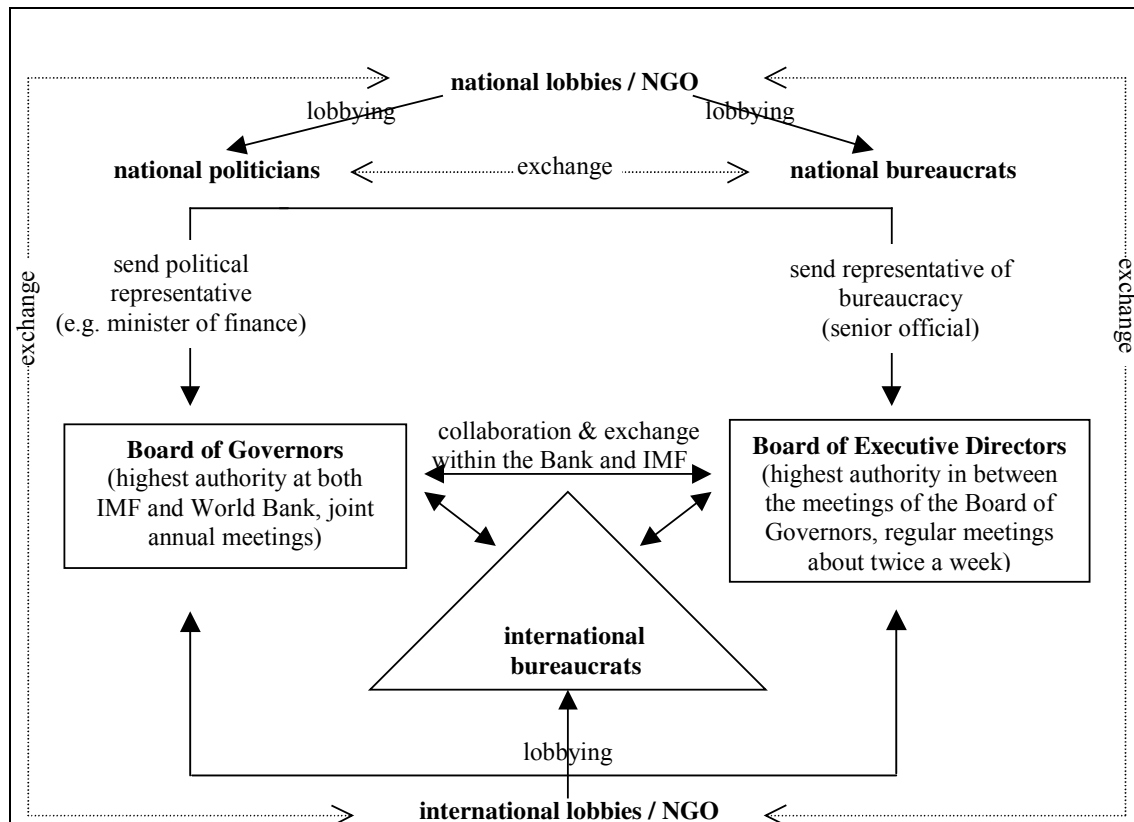
National politicians and bureaucrats can exert their influence via the two major decision making bodies of the IMF and the World Bank in which they are represented: the Boards of Governors and the Board of Executive Directors. The Board of Governors is

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<sup>4</sup> This incentive problem already existed in the original HIPC-Initiative. However, it was mitigated at least partly through the long-term evaluation of economic policies.

the highest political authority for all fundamental strategic and financing decisions. As governors meet only once a year, current decision making processes are delegated to the Board of Directors. Directors have full-time leadership functions within the bureaucracies of the two institutions. Since active politicians of national governments cannot themselves take over this task without giving up their political career, they tend to send a high level national civil servant. Although leaving the national bureaucracy for some time, links generally remain strong because the representatives have to be reintegrated later. Moreover, there is a mutual dependency on information flows.

**Figure 1: Political actors in World Bank and IMF decision making processes**



The two Boards both depend on the international bureaucracy to implement their decisions and to provide them with regular information. Due to the enormous difficulties to control a huge international civil service, it enjoys considerable power and can effectively oppose any policy decision by blocking its implementation. At the same time, through its selection of information flows, it can influence the boards' decisions. It

thus appears that hardly any significant policy change will be carried out at the Bank or the Fund if this is against the interests of its staff.

Essentially at all levels, interest groups can try to exert their influence through lobbying. In the case of HIPC debt relief the relevant interest groups are national and international NGO. They try to convince national politicians and bureaucracies, but are also present at the international level.

Now all of these actors have their specific interest in the policy decisions around HIPC II. These interests will be analyzed in order to see whether they can explain the new orientation of the enhanced debt relief program.

#### **4.1. The political actors' utility maximization problems**

The interests of different political actors can be presented in terms of their utility functions. Public choice theory generally assumes that the utility of politicians depends on (expected) votes at the next election, while the utility of bureaucrats depends on their budget, prestige, pleasant working conditions and room for discretionary decisions. NGO certainly also care for their prestige and budget which is, after all, a precondition of their survival and potential growth.<sup>5</sup>

How does the Enhanced HIPC-Initiative affect the utility of these groups? National politicians will compare debt repayment to debt relief considering that repayment leads to fresh resources that can be used to attract new votes. However, as the default risk increases, the expected value of repayment decreases and, in the extreme case of a default risk of 100%, utility gains of waiting for repayment become zero.

At the same time, politicians can also win some votes through debt relief. Debt relief to poor countries has a high moral appeal since it intuitively appears to be an act of charity for the needy. The utility maximization problem of politicians thus consists in weighing the potential gains in votes through repayment against the potential gains in votes through debt forgiveness. Obviously, if it becomes transparent that the default risk is very high and that repayments can hardly be expected anyway, proponents of debt relief for charity reasons will value this relief much less. Assuming that knowledge about

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<sup>5</sup> For a more detailed discussion of NGO's utility function see Michaelowa 1998 (pp. 70-73).

default risk is proportionate to the default risk itself, utility gains through debt forgiveness decrease with the default risk.

More formally, and assuming linear relationships, we can thus express the utility of politicians in creditor country  $i$  with claims against country  $j$  as:

$$U_{ij}^p = \begin{cases} U_{0i} + U_{fij}^p & \text{if debt is forgiven} \\ U_{0i} + U_{p_{ij}}^p & \text{if debt is not forgiven} \end{cases} \quad (1)$$

$$U_{fij}^p = a_0 - a_1 R_{ij}, \quad a_0 \geq a_1 > 0 \quad (2)$$

$$U_{p_{ij}}^p = b_0 - b_1 R_{ij} \quad b_0 = b_1 > 0 \quad (3)$$

where:

$U_{ij}^p$  utility of politicians in creditor country  $i$  with claims against country  $j$

$U_{0i}$  utility of politicians in country  $i$  independent of their claims against country  $j$

$U_{fij}^p$  utility gains of debt forgiveness towards country  $j$

$U_{p_{ij}}^p$  utility gains of waiting for the payment of country  $j$

$R_{ij}$  risk of default (in terms of probability, i.e.  $0 \leq R_{ij} \leq 1$ ).

The parameters  $a_0$ ,  $a_1$ ,  $b_0$  and  $b_1$  are defined to ensure that  $U_{fij}^p(R_{ij})$  and  $U_{p_{ij}}^p(R_{ij}) \geq 0$  for all  $R_{ij}$ , and that  $U_{p_{ij}}^p(R_{ij}=1) = 0$ .

Now in order to maximize their utility, politicians will compare  $U_{fij}^p(R_{ij})$  and  $U_{p_{ij}}^p(R_{ij})$ . At a default risk of zero, we can expect that the utility of waiting for a repayment is higher than the utility of debt forgiveness, i.e.:

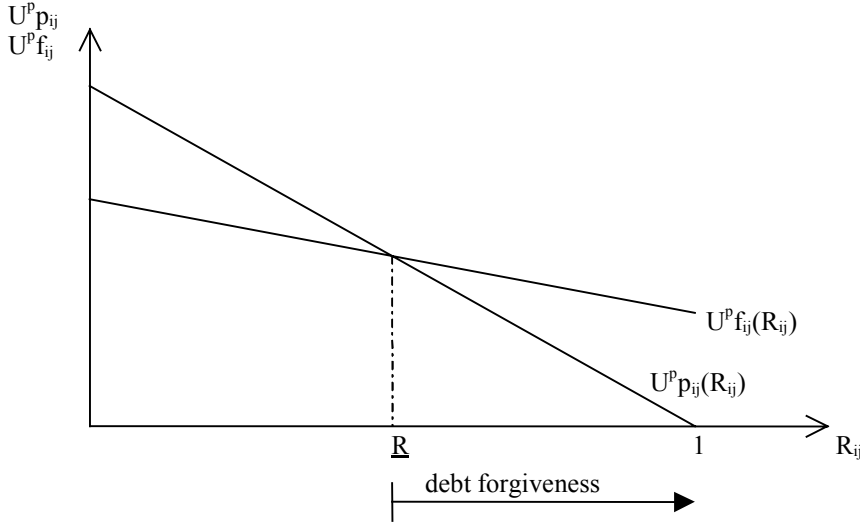
$$U_{p_{ij}}^p(R_{ij}=0) > U_{fij}^p(R_{ij}=0) \quad \Leftrightarrow \quad b_0 > a_0 \quad (4)$$

Otherwise it would be very difficult to explain why the credit was given in the first place. Parameter restrictions in (2), (3) and (4) imply that politicians' optimal choice always depends upon  $R_{ij}$ . Equating  $U_{fij}^p(R_{ij})$  and  $U_{p_{ij}}^p(R_{ij})$  we can calculate the point  $\underline{R}$  at which politicians are indifferent between the two policy options. At any default risk higher than  $\underline{R}$  they will opt for debt relief.

$$\begin{aligned} U_{fij}^p(R_{ij}) &= U_{p_{ij}}^p(R_{ij}) \\ a_0 - a_1 R_{ij} &= b_0 - b_1 R_{ij} \\ R_{ij} &= (b_0 - a_0) / (b_1 - a_1) \equiv \underline{R}, \quad 0 < \underline{R} \leq 1 \end{aligned} \quad (5)$$

Figure 2 graphically illustrates the two relevant components of the politicians' utility function and summarizes the above discussion.

**Figure 2: National politicians' choice between policy options**



Thus in each creditor country  $i$  and with respect to each debtor country  $j$  national politicians will favor debt relief if  $R_{ij} > \underline{R}$ . The default risk  $R_{ij}$  depends on a number of characteristics of both partners such as the retaliation power of the creditor, cumulated arrears, and the debtor's total debt with respect to the size of his economy. We may thus write:

$$R_{ij} = f(\text{GNP}_i, (X+M)_{ij}, \text{ODA}_{ij}, (M-X)_j, \text{arrears}_j, \Sigma \text{Debt}_j) \quad (6)$$

The first three terms represent the economic power of the creditor and the debtor's dependency on bilateral trade and aid (Official Development Assistance, ODA). These factors can be assumed to diminish the risk of default since they represent the retaliation potential of the creditor. In contrast, the debtor's overall current account deficit  $(M-X)_j$ , i.e. his continuous need for external finance, arrears that he has already accumulated, and total accumulated debt imply an increasing risk of default.

Let  $p_{ij} = p(R_{ij} > \underline{R})$  denote the probability that the politicians of country  $i$  are willing to forgive the debt of country  $j$ , and  $(1 - p_{ij}) = p(R_{ij} \leq \underline{R})$  the probability that they do not. Obviously  $p_{ij}$  depends on the same variables as  $R_{ij}$ .

Now for several countries, say the G7, to reach a consensus on joint debt relief for country  $j$  the probability is:

$$p_j = p(\bigcap_{i=1}^7 (R_{ij} > \underline{R})) = p_{1j} \cdot p(R_{2j} > \underline{R} \mid R_{1j} > \underline{R}) \cdot p(R_{3j} > \underline{R} \mid (R_{1j} > \underline{R}) \cap (R_{2j} > \underline{R})) \cdot \dots \quad (7)$$

For I creditor countries to agree on debt relief for J different debtor countries, it is:

$$p_{all} = p(\cap_{j=1}^J [\cap_{i=1}^I (R_{ij} > \underline{R})]) \quad (8)$$

This probability depends on all explanatory variables of  $R_{ij}$  (for all i and j), notably on accumulated debt and arrears. Thus rising debt stock and arrears as observed during the last three decades lead to a rising probability of joint debt relief.

Nevertheless, the probability that politicians of all relevant creditor countries find it optimal to simultaneously forgive the debt of a considerable number of developing countries, appears to be rather small. By definition,  $p_{all} \leq p_j \leq p_{ij}$ . Since creditor countries vary considerably with respect to their retaliation potential and country focus, there is only little probability that they reach  $\underline{R}$  at exactly the same point of time and with respect to the same debtor countries. Now if politicians in country i find it individually optimal to proceed with debt relief for country j, they will do so without losing time and even if they don't find a partner for joint action. In the past, this bilateral relief has mainly taken place indirectly, via an input of fresh ODA resources. In an econometric study, Birdsall, Claessens and Diwan (2001) show to what extent debt has affected the provision of new aid resources since the late 1970s. Bilateral aid reduces the default risk  $R_{ij}$  faced by i for the remaining credits outstanding from country j (see equation (6)). Thus if now, another creditor starts to think about debt relief for this same debtor, politicians in country i will no longer join the effort. Thus bilateral action reduces the probability  $p_{all}$  of joint action by all donors.

Conventional debt overhang theory would add that the probability to reach an agreement will be reduced because of free riding behavior among creditors. This point does not seem very convincing here since the group of major creditors as represented at G7 meetings, is sufficiently small to reach an agreement if this is indeed of interest to all participants. Nevertheless, it can be concluded that the probability of a comprehensive multilateral debt reduction program such as HIPC II with 41 potentially eligible countries is generally not very probable to be implemented. Although the probability rises over time with increasing cumulated debt and arrears, a temporary shock would be needed to push politicians of various countries across the threshold  $\underline{R}$  at the same time. We will see whether this might have come about through the interaction with other groups of political actors.

Let us now consider national bureaucrats in donor countries. Their utility depends on their budget, prestige, pleasant working conditions and the room for discretionary decisions. The effect of debt relief on the budget depends on whether any payback from the debtor can really be expected. This expectation depends on the default risk  $R_{ij}$ . If repayments can be expected, they are of interest for bureaucrats only if resources flow back into their own administration and not into some general pool at the discretion of politicians. Finally, the effect on bureaucrats' budget depends on whether there is an agreement on the additionality of funds earmarked for debt relief, or whether the relief draws on the general aid budget. At one extreme, the full NPV of relief will be added to their budget, which is the option bureaucrats will obviously favor. Since expected value of repayments is generally lower than the NPV of outstanding debt, they would actually receive more funds than they could ever have expected to recover from the debtors. Estimations show that overall, HIPC debt is probably worth only about 10% of its NPV (Cohen 2000, p. 22). In this case, debt relief under full additionality will actually increase their budget by 90% of outstanding debt.

At the other extreme, they do not receive any extra funds and debt relief is financed out of unchanged ODA, i.e. there is no additionality. Of course, there is a multitude of intermediate financing possibilities. However, we can suppose that, other things being equal, bureaucrats will oppose any debt relief program that does not provide for a minimum compensation covering at least their real budgetary loss.

Formally we can write:

$$\text{Comp}_{\max} = \text{NPV} \quad \Rightarrow \quad \Delta B_T = \Delta B_T(R_{ij}) = \Delta B_F(R_{ij}) + \text{NPV} \quad (9)$$

$$\text{Comp}_{\min} = \text{Comp}(R_{ij}) = -\Delta B_F(R_{ij}) \quad \Rightarrow \quad \Delta B_T = 0, \quad -\text{NPV} \leq \Delta B_F(R_{ij}) \leq 0 \quad (10)$$

with

$\text{Comp}_{\max}$       compensation under full additionality

$\text{Comp}_{\min}$       minimum compensation bureaucrats are willing to accept

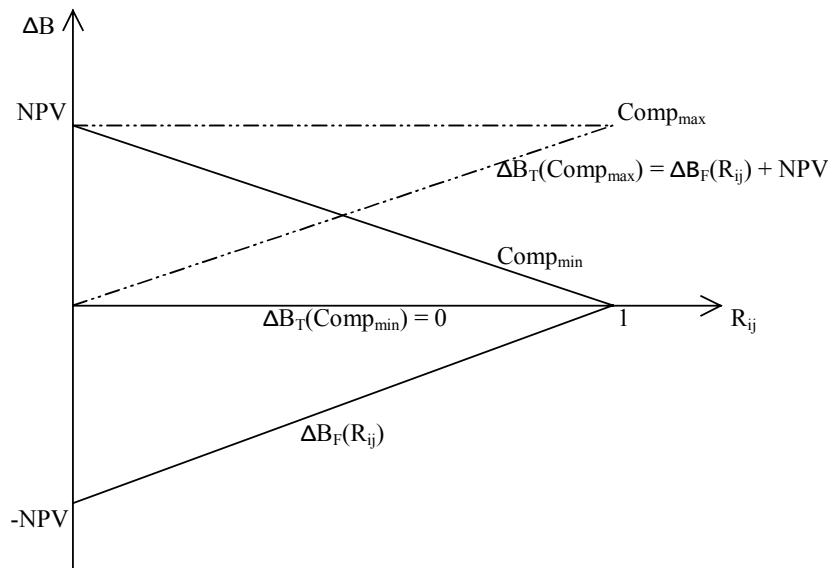
$\Delta B_T$       total budget effect for bureaucrats

$\Delta B_F$       budget effect of debt forgiveness (without compensation)

This is illustrated in Figure 3.



**Figure 3: The effect of debt relief on national bureaucrats' budget**



Note that, under purely budgetary considerations, the minimum amount of compensation bureaucrats require to accept the deal ( $Comp_{min}$ ) just corresponds to the amount of resources politicians expect to lose through debt forgiveness. These are the funds lost for the donor country as a whole. Politicians will not agree on a compensation to bureaucrats higher than that, otherwise they will handle the relief without the intermediary of the national aid administration.<sup>6</sup>

However, in their utility maximization process, bureaucrats do not consider the budget alone. The impact on prestige, pleasant working conditions and room for discretionary decisions also depends on the concrete arrangements. One particular aspect of the HIPC II debt relief is the link to poverty reduction through the elaboration of PRSP. Now, in particular since the beginning of the 1990s, the aid bureaucracy finds itself under increasing pressure to raise the share of resources spent into poverty reduction. The peer reviews of the OECD's Development Assistance Committee (DAC) tend to focus on this issue (see e.g. OECD/DAC (1998, pp. 31ff.). Special DAC guidelines for donor countries' poverty reduction strategies have just been published as a new point of reference (OECD/DAC 2001). However, clearly poverty related programs are very

<sup>6</sup> In the framework of a principal-agent model one might also assume that the bureaucracy has better information on real default risk than national politicians, so that the former tend to exaggerate real expected losses in order to gain higher compensation. In order to reduce the complexity of the model, these aspects are not taken into account here.

difficult to design and generally do not consume huge sums of money. Other projects are much more easy to plan, to implement and to monitor. Now the invention of PRSP makes work much easier for the aid administration in donor countries. Whatever project it may be, if it can be adjusted to fit into a PRSP, it automatically obtains the positive stamp of poverty reduction. This simultaneously contributes to a reduced workload and a rising prestige of the aid administration's development assistance program. In addition, national bureaucrats can get directly involved in drafting PRSP, thereby increasing their power and influence.

These side effects of the HIPC implementation process will increase national bureaucrats' willingness to engage in debt relief. If budgetary effects alone are taken into account,  $Comp_{min}$  is required to maintain a constant utility level. Now considering the effects on prestige and working conditions, bureaucrats receiving  $Comp_{min}$  will not just be indifferent but clearly in favor of debt relief. In fact, this implies that even if they do not receive a full compensation of their real budgetary losses, they will still accept the debt relief initiative.

Summing up the discussion on politicians and bureaucrats in creditor countries, we can say that once politicians have come to an agreement such as HIPC II, this agreement is very unlikely to face opposition by national bureaucrats even if the aid resources spent for this purpose are not fully compensated by additional ODA funds.

To complete the discussion of the national political processes let us now consider the position of NGO. NGO have always fought for debt relief to poor countries. The high moral appeal of the argument that poor people in developing countries should not suffer from malnutrition and lack of basic health and education because their governments have to pay back loans to the industrialized world is used by NGO for their own purposes. Complicated questions such as who will really reap the benefits of these funds and whether they might not provoke counter-incentives to good government policies tend to be overlooked by public opinion. Therefore, through campaigns on debt relief, NGO can easily gain publicity which in turn helps them to raise funds for their other activities. However, as it is difficult to sustain a long time public interest for always the same question, NGO tend to focus their major campaigns on special events or symbolic years. In 1988 for instance, the annual meeting of the World Bank and IMF's Board of Governors in Berlin was used for coordinated and intensive lobbying for debt relief. In 1996, they organized the campaign "50 years is enough" referring to the activities of the Bretton Woods institutions in general. Now, a new and particularly well suited

opportunity arose with the year 2000, entrance to the new millenium and biblical year of debt forgiveness. With the “Jubilee 2000 Coalition Initiative” a huge NGO campaign for debt relief was launched involving all major development NGO including the big churches. Planning for this event started as early as 1994, and by 1997, many organizations all over the world had joint the network (Menzies 2001, pp. 6ff.). Around that time it must have been clear to all observers that debt relief would become a major issue of public debate during the year 2000.

Now what does this mean for the utility maximization of bureaucrats and politicians in creditor countries? With public interest turned onto debt issues by NGO campaigns, politicians can expect that debt forgiveness will not go unnoticed but obtain broad public support. At high times of NGO campaigning they can thus expect to attract more votes through debt relief than they would at other times. Since this is true irrespective of default risk  $R_{ij}$ , we can rewrite national politicians’ utility from debt relief (see equation (2)) for periods of major NGO lobbying as:

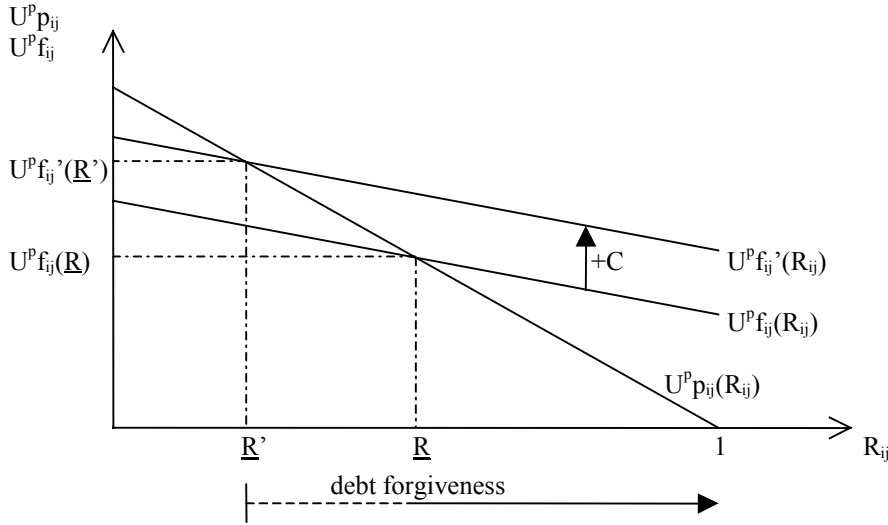
$$U_{ij}^{Pf'} = a_0 - a_1 R_{ij} + C, \quad C > 0, \quad (11)$$

where  $C$  is a constant term reflecting the impact of NGO activities on voters’ behavior. Calculating the default risk above which politicians in creditor country  $i$  will find it optimal to forgive the debt of country  $j$  now yields:

$$\underline{R}' = [b_0 - (a_0 + C)] / (b_1 - a_1) < \underline{R} = (b_0 - a_0) / (b_1 - a_1). \quad (12)$$

This means that due to NGO campaigning, creditor countries’ politicians will find it optimal to forgive the debt at a lower level of default risk than before. They will thereby reach a higher level of utility ( $U_{ij}^{Pf'}(\underline{R}')$ ). This “Jubilee 2000 effect” is illustrated in Figure 4.

**Figure 4: The “Jubilee 2000 effect” on national politicians’ utility maximization**



Since the “Jubilee 2000 effect” occurs in all creditor countries and with respect to all debtor countries, the probability of reaching an agreement on comprehensive debt relief rises from  $p_{all}$  to  $p_{all}'$ .

$$p_{all}' = p(\cap_{j=1}^J [\cap_{i=1}^I (R_{ij} > \underline{R}')]) > p_{all} = p(\cap_{j=1}^J [\cap_{i=1}^I (R_{ij} > \underline{R})]) \quad (13)$$

Moreover, it is important to note the additional dynamic effect not captured by this inequality: Lobbying focussed on a particular single year leads to a *simultaneous* shift of all creditor-debtor relations with default risks between  $\underline{R}$  and  $\underline{R}'$  across the threshold of optimality for debt relief. This implies that the coordination problem arising through immediate individual action after crossing the threshold will be far less relevant here.

Together with the general rise of default risks  $R_{ij}$  over time, the “Jubilee 2000 effect” may thus be responsible for the unprecedentedly comprehensive debt relief initiative launched by government representatives at the G7 meeting 1999 in Cologne. As discussed above, opposition from national bureaucrats was not to be expected as long as they were promised some budgetary compensation - not even necessarily as high as real budgetary losses. It remains to be discussed how this could translate into an international agreement involving the World Bank and the IMF and reducing the conditionality requirements imposed by these agencies.

Since according to equation (6), each  $R_{ij}$  depends on total accumulated debt and total arrears of country  $j$ , an individual creditor will benefit from other creditors equally granting debt relief. G7 creditor countries will thus also benefit from the forgiveness of World Bank and IMF loans and they will try to pass corresponding decisions at the Boards of these organizations. It is probable that they will be supported by governors and executive directors of other OECD creditor countries where the national political decision making process follows the same lines as outlined above. Poor debtor countries potentially eligible for debt relief, will certainly not oppose the agreement, while the remaining countries will not show any particular preferences as long as they are not expected to participate in the financing of the relief program. There are thus very high chances of a broad consensus in favor of debt forgiveness.

For the international bureaucracy, under certain conditions, a program such as HIPC II can be a welcome chance of improving their public image, replenishing their funds, enhancing lending activities and dissimulating their debtors' upcoming default problems. Just as for national politicians and bureaucrats, improving their image through debt relief works particularly well at times during which NGO focus their lobbying activities on the "moral obligation" to deliver poor countries from their debt burden. At these times, public interest in debt relief is particularly high and the international bureaucracies can expect higher prestige if they respond to this public interest. Moreover, debt relief leads to benefits from more consensual working relations with NGO. It can thus be expected that the "Jubilee 2000 effect" plays an as important role for the utility maximization process of international bureaucracies, as it does for national decision making processes.

At the same time, replenishing the funds for new lending and dissimulating upcoming default problems is the more relevant, the higher the default risk of debtor countries with respect to multilateral debt. While HIPC I had left these financial issues largely unresolved, HIPC II led to the creation of the IMF's Poverty Reduction and Growth Facility (PRGF) replacing the Enhanced Structural Adjustment Facility (ESAF), and to considerable bilateral commitments to the HIPC Trust Fund managed by the World Bank. These resources linked to multilateral debt relief do not create any additional financing capacity as long as full repayment of loans can be expected. With increasing default risk, however, the funds received for debt forgiveness in NPV terms exceed repayment expectations, and the international bureaucracy benefits from real budgetary gains.

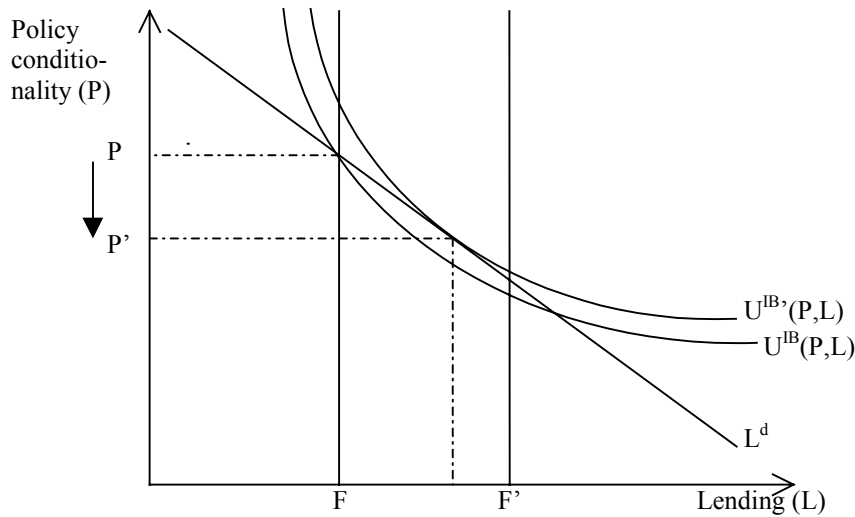
Since the utility international civil servants derive from debt relief thus depends on just the same parameters as those relevant for national politicians and bureaucrats, it is highly probable that at times the official decision making boards of IMF and World Bank come to an agreement on debt relief, this will also meet the utility maximization requirements of the international bureaucracy.

Once a common agreement is reached, funds will be made available by member states. Now as the implementation of debt relief is left to international bureaucrats, they will have to find ways how to spend these funds. Rapid debt relief for a considerable number of developing countries would not have been possible under the initial HIPC-Initiative since developing countries' governments were simply not interested at the given strict policy requirements. At unchanged world demand, World Bank and IMF had to reduce the conditionality requirements attached to their lending. Consequently, the shift to HIPC II implied a considerable weakening of conditionality.

More formally, and following Vaubel (1991, pp. 233ff.), international bureaucrats' utility ( $U^{IB}$ ) can be modeled, *ceteris paribus*, as a positive function of both lending ( $L$ ) and policy conditionality ( $P$ ). While lending is important in order to prove budgetary requirements, policy conditionality positively effects the bureaucrats' discretionary power. The utility of international bureaucracies is constrained by the demand for their lending ( $L^d$ ) and the quota and / or financing facilities ( $F$ ) from which they can lend.

Now imagine that, initially, the financing constraint is binding since original financing facilities have dried out due to missing flow back from earlier lending. Figure 5 illustrates that this leads to a relatively high policy conditionality ( $P$ ). Relaxing the financial constraint from  $F$  to  $F'$  implies a higher level of utility for international bureaucrats ( $U^{IB'}$ ) at weakened policy requirements ( $P'$ ).

**Figure 5: International bureaucrats' utility maximization and its effect on conditionality**



Source: Vaubel (1991, p. 234, Figure 1b).

It becomes clear that (as interest rates are fixed in advance at almost negligible levels) the degree of conditionality can actually be interpreted as the price on the market for international lending. When IMF and World Bank funds are easily available, i.e. when the lending constraint  $F$  is relaxed through the replenishment of funds to  $F'$ , this price will go down. Thus HIPC II necessarily implies a reduction of conditionality. This is precisely the phenomenon observed which we had difficulties to explain on the grounds of normative economic reasoning.

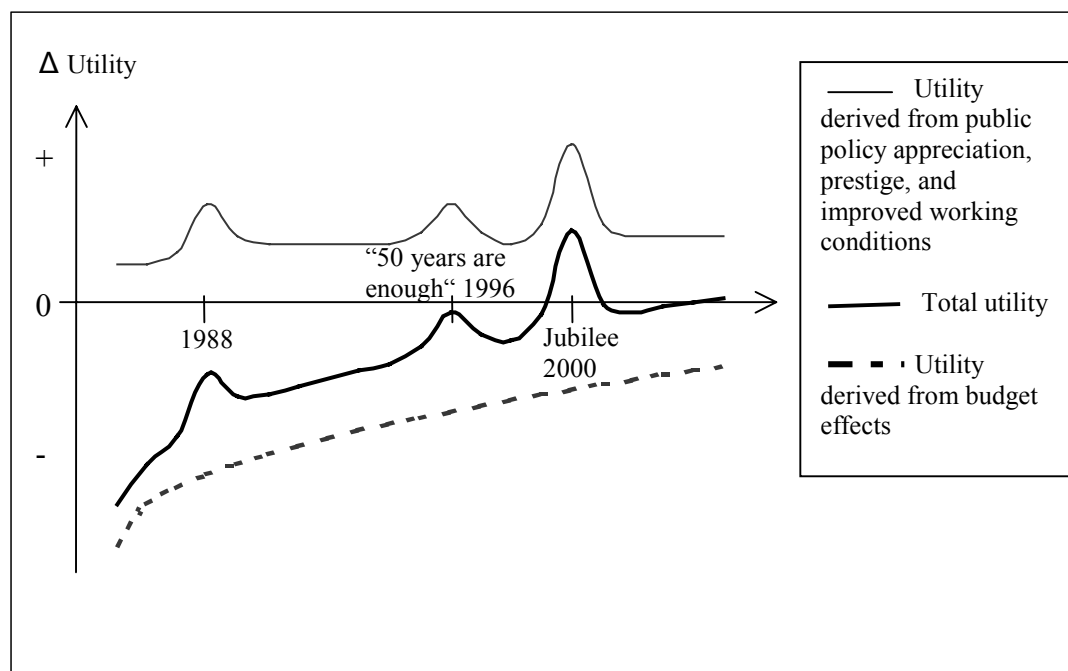
#### 4.2. Empirical evidence

As we have seen, positive analysis can provide a theoretical explanation for the Enhanced HIPC-Initiative. However, it seems important to examine to what extent this theoretical explanation is consistent with empirical evidence. In particular, the argument that HIPC II was endorsed in 1999 rather than at any other point of time, relies on two pillars:

- the “Jubilee 2000 effect”, and
- the overall increase of poor development countries' default risk over time.

Figure 6 summarizes the importance of these two factors for the decision making process of virtually all relevant actors determining World Bank and IMF policy.

**Figure 6: Utility from comprehensive debt relief for the World Bank and IMF**



With generally increasing risk of default, expected repayments decrease, and so do the utility losses induced by real negative budget effects of debt relief (lowest line). At the same time, public appreciation of debt relief rises around certain years of particular NGO lobbying such as, in particular, the Jubilee 2000 Initiative at the beginning of the new millenium. This public appreciation translates into higher votes for politicians and higher prestige and / or more pleasant working conditions for bureaucrats. In 1988, this campaigning had no effect since at least multilateral donors could still expect a pretty complete repayment of their debt. In 1996, the campaign “50 years are enough” and the prevailing default risk were still not fully sufficient to shift total utility of debt relief significantly above the level of indifference ( $\Delta \text{Utility} = 0$ ). Therefore, the initial HIPC-Initiative was endorsed, but never reached a significant scale. In the year 2000, however, total utility of comprehensive debt forgiveness clearly became positive.

Let us first check the empirical evidence of an increasing default risk, both with respect to selected individual creditor countries and with respect to lending by multilateral



institutions. From equation (6) we retain those determinants of  $R_{ij}$  that do not depend on the creditors themselves<sup>7</sup>, i.e. total debt, arrears, and the balance of trade deficit. The development of these indicators over time is presented in Table 3.

**Table 3: Selected indicators of HIPC default risk over time<sup>1</sup>**

	1970-74	1975-79	1980-84	1985-89	1990-94	1995-99
Total long-term debt outstanding and disbursed (LDOD)	9,567	26,118	59,360	111,879	167,807	175,953
Debt forgiveness or reduction	..	..	..	-4,147	-2,142	-4,912
Multilateral debt/total debt (%)	11.6	13.6	16.0	20.0	22.4	27.6
Interest arrears on LDOD	121	911	2,764	6,154	15,839	18,007
Principal arrears on LDOD	172	1,128	3,123	11,431	33,833	43,094
Current account deficit <sup>2</sup>	..	..	9,999	11,491	17,447	20,075

<sup>1</sup>In millions of current US\$, if not otherwise specified.

<sup>2</sup>Excluding transfers, i.e. only imports minus exports of goods and services. Note that foreign direct investment that could, in principle, offset the deficit, is negligible for HIPC.

Source: World Bank (2001c).

We note that indeed, total outstanding debt and arrears steadily increased over time, despite some bilateral debt forgiveness already taking place since the mid 1980s. The increase slowed down in the mid 1990s when donors started to replace loans by grants. At the same time, the share of multilateral credits within total credits rose continuously. Finally, net imports were increasing, so that HIPC's need for external finance rose rather than fell over time. Towards the end of the 1990s, it could obviously not be expected that they would ever be able to fully pay back their credits out of their own resources.

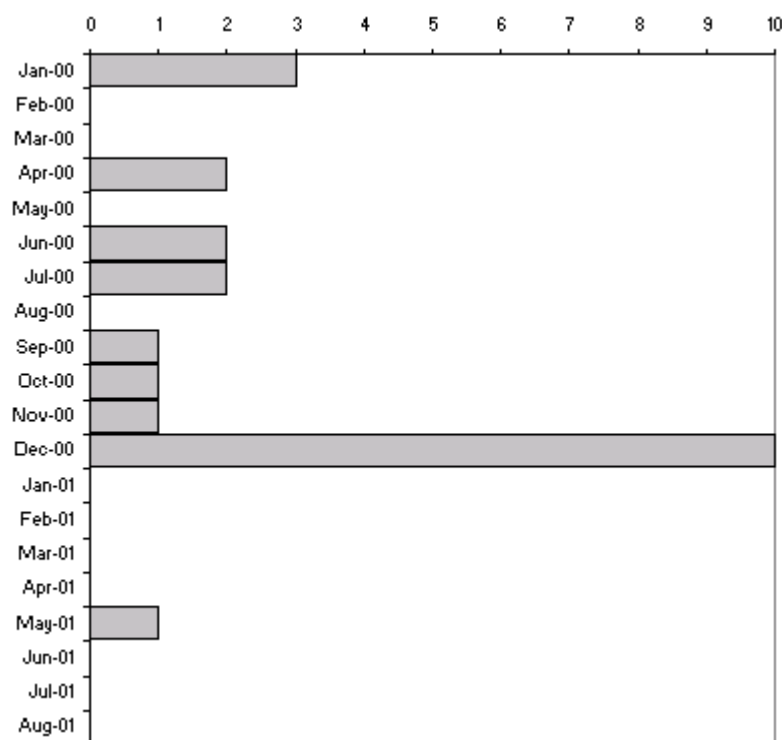
Let us now check the evidence for the "Jubilee 2000 effect". If there were no special effect leading to a particular increase in utility from debt relief for the relevant political actors during the year 2000, we would expect a rather continuous picture of countries passing the HIPC decision point. Moreover, while each HIPC would probably try to speed up the process in order to benefit from relief measures as quickly as possible, we could expect the World Bank and the IMF to watch over a thorough PRSP development and to insist on sufficient time to allow for broad participation.

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<sup>7</sup> The latter are relevant only relative to other donors and not for the donor community as a whole.

Now looking at country-case studies of PRSP or Interim-PRSP development, it seems as if the World Bank and the IMF, rather than the countries themselves, created the time pressure that often severely impeded serious participation by CSO (see e.g. Marshall and Woodroffe 2001, p. 31). Moreover, it appears as if every possible effort had been made, to pull the endorsement date of the Interim-PRSP within the year 2000. Figure 7 shows, that during the year 2000, 22 out of 41 HIPC got their Interim-PRSP accepted by the international agencies. Almost half of them passed the decision point just before the end of the year. Of the remaining 19 countries theoretically eligible, only one passed the decision point until August 2001. Evidence is thus clearly consistent with the theoretical argument of a “Jubilee 2000 effect”.

**Figure 7: Number of Interim-PRSP endorsed by the World Bank and IMF**



Sources: IMF/IDA (2001, p. 5) and World Bank (2001d, p. 13).

## 5. Conclusions

Comprehensive debt relief as it is currently delivered under HIPC II is difficult to explain on the grounds of normative economic analysis. A politico-economic model, based on the utility maximization of all political actors participating in the decision making process, does, however, give some insight into how the Enhanced HIPC-Initiative might have come about. It appears that, when politicians and bureaucrats realize that default risk becomes very high, they prefer to grant debt relief in order to mask their imprudent lending and to “sell” the renunciation of funds as an innovative poverty reduction measure.

NGO lobbying, in particular via focused and well organized activities at specific occasions such as the beginning of the new millenium, increases their chances of obtaining public credit for debt relief. This leads to the “Jubilee 2000 effect” simultaneously shifting the utility of many national and international political actors across the threshold of positive utility. Moreover, the “Jubilee 2000 effect” speeds up the political process of debt relief since all political actors try to reap the benefits of short-term public attention onto this particular policy issue.

However, offering a debt relief policy package and attracting demand among the eligible countries are two different things. While extra funds for debt relief are made available, this implies real benefits to HIPC only to the extent that they initially intended to pay back the loans which will be forgiven. Moreover, if debt is cancelled, they might lose an important lever for future ODA. In any case, they will not demand these extra funds at the prevailing high price of IMF and World Bank conditionality. Thus, once agreements on the provision of debt relief have been achieved, the implementation by international bureaucrats requires a reduction of conditionality in order to provoke demand for the new policy package.

Finally we end up with a policy product characterized by a multitude of at least partly contradictory objectives and implemented at a speed that in itself seriously interferes with the basic ideas of the process.

While the initial HIPC-Initiative was oriented towards rewarding countries for a long-term record of sound economic and social policies, the Enhanced HIPC-Initiative responds to the pressure not to wait for so long. Incentives for good policy orientation have thus become less relevant and policy shifts which could lead to a long-term

sustainable economic development have become less probable than before. Straightforward and transparent measures such as simply clearing the books of all credits with default risks close to 100%, remain as inconsistent with the new political equilibrium as they have been before.

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## **Appendix**

### **Abbreviations**

CSO	Civil Society Organizations
DAC	Development Assistance Committee
GDP	Gross Domestic Product
GNP	Gross National Product
HIPC	Heavily Indebted Poor Country(ies)
HIPC II	Enhanced HIPC-Initiative (endorsed in 1999)
IDA	International Development Association
IMF	International Monetary Fund
LDOD	Long-term Debt Outstanding and Disbursed
NGO	Non-Governmental Organizations
NPV	Net Present Value
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PRSP	Poverty Reduction Strategy Paper(s)